Converting stock options to other employees benefits

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Abstract (Document Summary)

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[Headnote]

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Stock Options Can Represent Significant Wealth

Stock options have become an extremely popular vehicle for providing extra compensation to employees, particularly at high-tech companies, I for at least three reasons. First, since the value of a stock option depends on

the future performance of the company, stock options are viewed as a way of "tying" compensation to company performance - both the company and the executive profit if the company's stock rises in value, and both suffer if the stock price declines. Second, Section 162(m) of the Internal Revenue Code, adopted in 1993, places certain limits on executive compensation, but those limits normally do not apply to "performance-based" compensation.' Stock options frequently are used to take advantage of this performance-based compensation exception to Code Section 162(m). Third, the very nature of stock options tends to "defer" compensation into the future. However, as will be discussed in this article, this limited type of deferral normally will not carry the executive to retirement.'

The growth in stock prices over the last several years has increased the value of stock options for many. The explosion of potential wealth through stock options, particularly for younger employees, has become a favorite topic for the media.

No phenomenon has spread the wealth more - or made it feel more random - than stock options. Options emerged in the late 80's.... Silicon Valley firms gave them to most employees to offset the low pay of a start-up or compensate for long hours.... Atlanta has legions of Home Depot and Coke option millionaires. Option wealth is spreading through New York's Silicon Alley, through other high-tech centers around the country, and also in oldline companies like GM and Ford.

"There's nothing more disturbing than other people's stock options, " says Richard Cohen, a clinical psychologist in Berkeley, CA.4

Stock Option Basics

A recent article in this Journal thoroughly described stock options and covered the primary tax rules on stock options.' As a result, stock options and the primary tax rules are only discussed to the extent relevant to the planning alternatives discussed in this article.

Typically, a stock option is a right granted to an executive of a corporation to purchase a share of stock of the corporation at a specified price (referred to as the "strike price" or the "exercise price") within a certain period of time (referred to as the "exercise period"). If the strike price is below the market price of the stock, the option is described as being "in the money." If the strike price is higher than the market price, the stock option is "under water." For example, if the fair market value of the stock is $ 10 per share and the strike price under the option is $8 per share, the stock option is "in the money" by $2 per share. In many cases, at the time the option is granted, the strike price will be equal to the fair market value of the stock; thus, the stock option will be neither "in the money" nor "under water."

Comparison of Qualified (or Statutory) Options and Nonqualified (or Nonstatutory) Options

There are two types of options for tax purposes - qualified options (QSOs) and nonqualified options (NSOs). In general, QSOs are provided favorable tax treatment (from the employee's point of view). There typically will be no income tax at the time the QSO is granted; there will be no income tax when the option is exercised (unless the employee is subject to alternative minimum tax); and any gain on a subsequent sale of the stock will be taxed at long-term capital gain rates.6 Since the employee generally will be happy with the tax consequences of the QSOs, the employee will not be overly enthusiastic about converting QSOs into some other type of benefit. As a result, the planning techniques discussed in this article generally would not be of interest to an employee who holds only QSOs.

In contrast, the tax treatment of NSOs is not as favorable. Assuming the NSO does not have a "readily ascertainable value'" for tax purposes, at the time the NSO is granted there will be no income tax consequences to the employee. However, when the employee exercises the NSO, the built-in gain on the NSO will be treated as compensation income (taxed at ordinary income tax rates).' For example, if the employee exercises the NSO when the fair market value of the stock is $30 and the strike price is $20, the built-in gain of $ 10 will be taxed to the employee as ordinary income. Between 40 and 50 percent of the gain may need to be paid as federal and state income taxes, depending on the income tax rate for the applicable state.9 The employee will need to find cash to pay the tax (and/or the corporation will need to find cash to pay the withholding taxes).10 In addition, the built-in gain will be subject to the Medicare tax (1.45 percent on the employee and 1.45 percent on the corporation) when the employee exercises the NSO.11

The general tax consequences for qualified and NSOs are summarized in Table 1.

If the employee exercises the NSOs, does not spend the money received from the exercise of the NSOs, and the subsequent transfer of that wealth to the next generation is subject to estate tax, less than 30 percent of the built-in gain may be available to the next generation. For example, assume the employee recognizes $1 million of built-in gain as taxable income upon exercise of the NSOs. If the employee is subject to a 45 percent combined federal-state tax rate, the employee will pay $450,000 in additional income taxes and will have $550,000 left. If the employee does not spend the $550,000 during his or her lifetime and it is included in the employee's federal gross estate and taxed at a 55 percent rate, the next generation will receive only $247,500.

Timing of a Nonqualified Option

Frequently, an NSO will need to be exercised within 10 years of the date on which it was granted (or the option will expire)." For example, if an employee was 40 in 1990 and was granted NSOs, the options might be exercisable for 10 years. In that case, the employee must exercise the options before the end of the millennium (or the options will expire), when the employee is only 50 years old. At age 50, the employee may be at his or her peak eaming level; the employee may have no need for the compensation income represented by the stock option builtin gain. The employee likely may not need to spend any of the money represented by the NSO until retirement, and the employee may never need to spend any of that value - instead, the employee may plan on passing that wealth on to the next generation. As a result, the employee may be in no hurry to trigger the 40 to 50 percent income (and employment) taxes on the built-in gain represented by the NSO.

Alternatives for Stock Option Planning

There appears to be a number of alternatives available to an employee in this situation, including:

1. A "postponement" or extension of the exercise period for the stock options;

2. An exercise of the NSO using "old and cold" shares of the stock;

[illegible]

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[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]

Enlarge 200%

Enlarge 400%

TABLE 1

3. The conversion of the NSO to a nonqualified deferred compensation ("NQDC") arrangement in which the benefit would be paid in the form of the corporation's stock;

4. The conversion of the NSO benefit to a NQDC benefit in which the benefit could be paid in cash in the future;

5. The conversion of the NSO benefit to benefits under a stock appreciation rights plan; and

6. The conversion of the NSO benefit to a split-dollar benefit or a combination of a split-dollar benefit and a NQDC benefit.

Surprisingly, there appears to be few IRS rulings or court cases on this topiC.13 Although this article discusses several planning alternatives, general tax principles, and analogous situations that would appear to be relevant, there is very little direct authority on this topic.

Extension of the Exercise Period of a Stock Option

Since the deadline for dealing with the stock option (the termination of the exercise period) may occur long before the employee needs any of the money represented by the built-in gain on the stock option, one alternative is to extend the NSO exercise period. Unlike a qualified stock option (which cannot have an exercise period in excess of 10 years),14 there generally is no outer limit on the exercise period for a NSO.15

In Private Letter Ruling 94-31021, the IRS considered a situation in which a corporation transferred restricted shares of its common stock to an employee at no cost to the employee. The restricted stock vested in increments of one-third each in the fifth, sixth, and seventh years after the grant of the restricted stock. The corporation and the employee proposed to extend (or postpone) the vesting dates of the restricted stock for various periods ranging from 17 months to 33 months. The IRS stated, "As long as the future services required of the employee were and continue to be substantial, the postponement of the vesting date of the nonvested shares of restricted stock will not in itself require the employee to include in gross income the value of those shares."16

The result in Private Letter Ruling 94-31-021 is somewhat surprising in light of the IRS's position regarding amendments to nonqualified deferred compensation (NQDC) arrangements, discussed later in this article. Although Private Letter Ruling 94-31-021 is favorable, it leaves many questions unanswered, such as the following.

1. Would the IRS have permitted the extension (or postponement) if the employee had a stock option rather than restricted stock?

2. Would the IRS permit the same type of postponement if the employee had a vested stock option (in other words, was the presence of the substantial risk of forfeiture a key factor in the IRS arriving at a favorable ruling for the employee in Private Letter Ruling 94-31-021)?

3. What if the deferral period had been extended for a longer period of time (such as an additional 5 years), instead of 17 to 33 months?

The extension simply delays the ultimate tax consequences of the option, but it can provide needed "breathing room" in deciding how to deal with the NSOs. If the employee later exercises the option, he or she will pay income tax at ordinary rates,17 and any value from the builtin gain that is not spent before death may be subject to estate tax.

Exchange Involving "Old and Cold" Shares

Revenue Ruling 80-24411 suggests an approach for deferring part of the built-in gain on NSOs if the employee already owns stock of the corporation or holds QSOs - an exercise of the NSOs with "old and cold" shares.

Revenue Ruling 80-244 illustrates how this type of arrangement would work. In the ruling, the employee held both QSOs (to acquire 1,000 shares at a total strike price of $2x) and NSOs (to acquire 2,000 shares at a total strike price of $6x). The taxpayer first exercised the QSOs and acquired 1,000 shares for $2x. The value of the 1,000 shares then increased to $6x. The taxpayer next exercised the NSOs for a total strike price of $6x. Rather than paying cash to exercise the NSOs, the taxpayer used the 1,000 shares of stock acquired from the exercise of the QSOs (which now had a fair market value of $6x). Thus, as a result of exercising the qualified and NSOs, the taxpayer acquired 2,000 shares of stock (worth $12x) and only paid $2x in cash.

The IRS concluded that the taxpayer would not be taxed on the total $ 1 Ox gain ($12x - $2x), but instead would be taxed on only $6x of the gain. The IRS cited IRC Section 1036(a), which provides that no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation. They also cited IRC Section 1036(d), which states that if property is acquired in a Section 1036 exchange, the basis in the property received will be the same as the basis in the property exchanged. The IRS held that the exchange of 1,000 "old and cold" shares for 1,000 new shares qualified under IRC Section 1036 (because it was an exchange of stock for stock), and, therefore, the increase in value of those 1,000 shares ($6x $2x = $4x) was not taxed as a result of the exchange (the taxpayer's basis in those 1,000 shares remained at $2x). The IRS stated that the employee would recognize the remaining $6x gain as compensation income under IRC Section 83(a) (taxable at ordinary income rates), and the employee would have a tax basis of $6x in those 1,000 shares.

Revenue Ruling 80-244 suggests two planning opportunities when NSOs are granted. First, the corporation may issue QSOs to the employee at the same time the NSOs are granted. A major problem is that the amount of QSOs that can be issued to any one employee is severely restricted." Second, in order to "cover" the remaining shares that may be acquired by the exercise of the NSOs, the employee might purchase (on an after-tax basis) additional shares of stock of the corporation at the time the NSOs are granted. While this might act as a "hedge" against the future taxable gain from the exercise of the NSOs, this strategy may not be attractive to the employee since it will involve using cash currently to increase the employee's stake in the company (when the employee might be more interested in trying to diversify his or her investment portfolio). Furthermore, while Revenue Ruling 80-244 can be

useful in "deferring" part of the gain on the exercise of a NSO, if the employee later sells the stock during lifetime (for example, to help diversify his or her portfolio), the employee will be required to pay income tax on the builtin gain at that time.

If the employee holds the stock until death, this approach allows the employee to avoid paying income tax on part of the built-in gain.20 However, it requires planning when the NSOs are originally issued (which frequently is not done); a substantial portion of the employee's wealth may be tied up in the company's stock throughout his or her lifetime (which can be inconsistent with a goal to diversify investments). Furthermore, it does not provide a solution to the estate tax problem for the employee who desires to transfer the stock option wealth to the next generation.

Conversion to Nonqualified Deferred Compensation Benefits

This approach, and the approaches discussed in the remainder of this article, involve a "**conversion**" of the **stock** option into a **different type** of benefit. As a result, they all share certain issues in common. In particular, a key issue is whether these changes, amendments, and conversions will trigger immediate income tax under the "constructive receipt" doctrine, the "assignment of income" doctrine, or one of the other potential issues that may be raised.

It should be noted, as a preliminary matter, that whether a change of an employee benefit will trigger immediate tax liability may depend more on the "substance" of the change in light of all the particular facts and circumstances than on the "form" of the change. For example, one could argue that "postponing" the exercise date of a stock option for an additional five years may represent a more significant change than a "**conversion**" of a **stock** option that will vest in three years into a nonqualified deferred compensation benefit (that can only be paid in the form of company stock and will grow based on changes in the value of the company's stock) that will vest in 37 months.

The **conversion** of a **stock** option benefit to a nonqualified deferred compensation benefit can be illustrated by the following example.

In Year 1, Employee A receives stock options to purchase 1,000 shares for $5 per share, when the fair market value is $5 per share. The options expire in Year 10. In Year 9, the value has risen to $15 per share, and Employee A and the company agree that Employee A will surrender his or her stock options for a benefit under a nonqualified deferred compensation plan. Employee A's initial account balance under the nonqualified plan will equal the built-in gain in the stock options - in this case, $ 10,000.

The IRS recently issued a ruling on the **conversion** of a **stock** option into a nonqualified deferred compensation benefit. There are numerous questions left unanswered by this ruling, and it is unclear from the ruling itself exactly what some of the facts are. Nevertheless, Private Letter Ruling 9901-0061 appears to be the only IRS ruling that directly considers a **conversion** of a **stock** option into a nonqualified deferred compensation benefit. IRS letter rulings cannot be cited as precedent12 but can indicate how current law might be applied to an issue.

In Private Letter Ruling 99-01006, a parent company granted both QSOs and NSOs to employees of its subsidiary. The options did not have a "readily ascertainable fair market value" under Treasury Regulation Section 1.83-7 at the time of the grant. Each option was subject to a condition that the employee remain employed with the subsidiary for a three to five year period before the option could be exercised. The only exception to the vesting schedule was if an employee "retired.1123 The "Acquiring Company" purchased a stake in the Company's stock, and in connection therewith, the parent company provided the employees with the ability to elect to surrender the options in "exchange for an 'initial deferral amount' equal to the difference between the price at which the parent [company] sold its shares to Acquiring Company and the price at which the employee would have been able to exercise the option... multiplied by the number of shares ... covered by such option." Restated, the "initial deferral amount" would equal the built-in gain on the stock options. None of the employees involved were controlling shareholders.14 The IRS stated, "Distributions of the amount credited to any participating employee's hypothetical subaccount will occur within 30 days of the date on which the employees" would have become vested under the stock option plan." However, there is an "extended vesting schedule (by one year)" for certain key employees, "which is intended as a retention device for these key employees." The NQDC plan also contained a "change of control" provision (basically providing that an employee will become fully vested if his or her employment terminates upon a change of control)16 and provides for immediate vesting upon the employee's death.

The IRS analyzed Code Sections 83 and 402(b), the constructive receipt doctrine and the economic benefit doctrine, and concluded that the employees would not be taxed on the NQDC benefits until the employees receive

the cash payments. The IRS stated, "under the economic benefit and constructive receipt doctrines of sections 61 and 451 of the Code, neither the opportunity to surrender, nor the actual surrender of, QSOs and NSOs under the transaction stated above, will create taxable income to participating employees or their beneficiaries under the cash receipts and disbursements method of accounting."27

Many questions are left unanswered by Private Letter Ruling 99-01-006. First, there are questions involving the structure of the NQDC arrangement: (i) were benefits payable in cash? and (ii) were earnings added to the "initial deferral amount" based on the performance of the company's stock or on the performance of other designated investments (such as mutual funds), or was interest added at a fixed rate?21 Second, would the IRS have reached the same conclusion if various facts had been changed? (i) what if the stock options had already been vested and there was no vesting schedule under the NQDC arrangement? and (ii) what if the date for payments to begin had been significantly extended (in Private Letter Ruling 99-01-006, the only extension was for one year for certain key employees)?

A conversion to nonqualified deferred compensation can have disadvantages. In particular, the employee with a vested stock option has the ability to realize the built-in wealth at any time by exercising the option. As a result, the employee controls when he or she will enjoy the benefits. In contrast, an employee normally must terminate employment (or attain a certain age or number of years of service) before receiving NQDC benefits.19 Generally, a NQDC benefit arrangement can only be amended, if at all, with the consent of the company.10 In effect, once a NQDC arrangement is established, the employee loses control of the benefit.

In addition, generally NQDC benefits can only be offered to a "select group of management or highly compensated employees."31 Otherwise, a NQDC arrangement may be subject to the burdensome requirements of ERISA because it fails to meet the definition of a "top hat plan." Some commentators have suggested that a group of more than 5 percent of the company's total employees may constitute a "select group of management or highly compensated employees."" Thus, in many situations there may be employees who receive stock options but cannot be included in a top hat plan.

At best, a NQDC arrangement offers the employee a minimal amount of diversification. Diversification can be extremely important to an executive who already is dependent on the success of one company for his or her salary, bonus, and benefits. If the growth in the NQDC benefits will be measured by changes in the value of the company's stock and the benefits will be paid in company stock, there is no true diversification. Even if the growth in the NQDC benefits will be measured by the growth of other investments (such as mutual funds), ultimately the employee seeking to collect NQDC benefits is a general unsecured creditor of the company, and if the company goes bankrupt, the employee may receive pennies on the dollar, or nothing, for his or her NQDC rights.33

Both the extension of the exercise period and the conversion to NQDC benefits could result in converting part of the built-in gain that otherwise would be taxed as long-term capital gain on the ultimate sale of the stock into ordinary income (a bad result for the employee). The following example illustrates such a conversion:

In Year 1, Employee A receives a nonqualified stock option with an exercise price of $5 per share (and the fair market value of the stock is $5 per share). In year 4, Employee A exercises the option when the fair market value of the stock is $15 per share, and Employee A recognizes ordinary income of $ 10 per share. In year 10, Employee A sells the stock for $30 per share and recognizes long-term capital gain of $15 per share. In contrast, if Employee A and the employer merely extend the exercise period (or convert the built-in gain to a NQDC benefit), Employee A would recognize ordinary income of $25 in Year 10.

As in the case of an extension of the exercise period, the conversion to NQDC benefits will postpone the tax consequences of the arrangements until the triggering event (such as, attaining retirement age, disability, death, or other termination of employment). Thus, it can postpone the income tax for the employee who will use the benefits during retirement, but it does not provide any estate tax relief for the employee who desires to transfer the stock option wealth to the next generation.

In addition, there may be two significant problems for the employer. First, a conversion to NQDC benefits can have a significant negative impact on the employer's income statement in the year of conversion. As discussed in more detail at the end of this article, after the date the option is granted, the employer generally does not record the increase in the built-in gain on the stock options each year as a liability or as an expense. However, if the stock option benefits are converted to NQDC benefits, the employer will record the full amount of the NQDC benefit as an expense on its income statement (and as a liability on its balance sheet).

Second, when the NQDC becomes payable, the employer will need to pay the benefit out of its own funds. In contrast, with a publicly-held employer, the employer may view the employee's exercise of the stock options as a transaction between the employee and the "market" that does not require the use of the employer's own funds.

Conversion to a **Stock** Appreciation Rights Plan

A stock appreciation rights (SAR) plan is similar in many ways to a nonqualified deferred compensation arrangement, but the value of the benefit is tied to the performance of the corporation's stock, and the amount of the benefit typically is expressed in terms of "units."34 The employee will be granted a number of units that will correspond to some number (or fraction) of shares of the corporation's stock. If the value of the stock decreases, the units will have no value. If the value of the stock increases, the employee's benefit on exercise will be measured by the excess of the fair market value of the stock at the time of exercise over the fair market value of the stock on the date the unit was granted. The actual benefits under an SAR plan may be paid in cash or other "non-stock" property.

For several years, a key issue in connection with an SAR plan was whether the employee could have the unrestricted power to exercise the right at any time (and receive the benefit), and still not be taxed on the benefit until he or she actually exercises the right and receives the benefit. In Revenue Ruling 80-300,(35) the employee could not exercise the SAR in the first year, and if the employee failed to exercise before the end of the fifth year, the SAR would be deemed to have been exercised (at the end of the fifth year), and the employee would receive the benefit. In the ruling, the employee did not exercise the SAR and received the cash benefit at the end of the fifth year. The IRS held that the employee would not be taxed on the benefit until the end of the fifth year. The rationale for not taxing the employee on the value of the benefit after the end of the first year (when the employee could have exercised the right and received the benefit) was that (i) the constructive receipt doctrine causes immediate taxation only when the employee can reach the funds without the surrender or forfeiture of a "valuable right;"36 (ii) the employee's right to benefit from future appreciation of the stock was a valuable right; and (iii) the employee could not exercise the rights under the SAR without surrendering the opportunity to benefit from future appreciation of the stock. Thus, an employee could have the power to exercise SARs at any time but would not be subject to income tax until the employee actually exercised the SAR.

In Private Letter Ruling 88-29070,(37) the IRS ruled that if an employee can exercise a right, receive cash, and then "purchase a duplicate investment in the marketplace," the employee will be deemed in "constructive receipt" (and will be taxed immediately) on the amount of the benefit that can be withdrawn. Thus, it appears that Revenue Ruling 80-300(38) may only apply in the case of a true "SAR" plan in which the employee cannot duplicate his or her investment by purchasing the corporation's stock.

The advantages and disadvantages of converting a NSO benefit to a SAR arrangement are similar to converting to a NQDC benefit (in which the growth in the NQDC benefit is measured by changes in the value of the company's stock). In light of Private Letter Ruling 88-29-070, the employee will lose the ability to reach the wealth at any time. Also, there is no significant diversification, and there is no estate tax benefit for the employee who desires to transfer the stock option wealth to the next generation. In addition, the employer will need to record the value of the SAR benefit as an expense on its income statement for the year of conversion.

Conversion to Split-Dollar Benefits

Split-dollar arrangements have been discussed in many articles appearing in this Journal.39 As a result, this article merely discusses the rules for split-dollar arrangements to the extent necessary for this analysis. Split-dollar arrangements are described in Revenue Ruling 64-328,(40) which considered two types of splitdollar arrangements - collateral assignment split-dollar and endorsement split-dollar.

In collateral assignment split-dollar, the employee (or as discussed later, an irrevocable life insurance trust) acquires a life insurance policy on the employee's life. The employee (or the trust) owns the policy and grants a collateral assignment in the policy to the company. If the company pays all the premiums, the employee will be required to include an amount in his or her taxable income based on the lower of (i) the P.S. 58 rates, or (ii) the insurer's current published premium rates per $ 1,000 of insurance protection charged for individual one-year term life insurance available to all standard risks (the "Insurer's Published Rates").41

Revenue Ruling 64-328 indicates that the benefits under the policy can be "split" in a few different ways. Specifically, Revenue Ruling 64-328 says that the company will receive "an amount equal to the cash surrender

value, or at least a sufficient part thereof to equal the funds it has provided for premium payments."42 In an "equity" split-dollar arrangement, the amount repaid to the company at the employee's death or upon the termination of the agreement or the policy will be limited to the premiums paid - in effect, any excess "equity" in the policy (the excess of the policy's cash surrender value over the premiums paid) will benefit the employee (or the trust).43 In a "non-equity" split-dollar arrangement, the company receives an amount equal to the full cash surrender value of the policy upon the employee's death or the termination of the agreement or the policy.

In the endorsement method, the company owns the policy and "endorses" certain rights to the employee (or a trust), such as the right to name the beneficiary of part of the death benefit. The benefit "split" can be the same as under the collateral assignment method.

As mentioned above, if the company pays the premiums on the policy, a split-dollar arrangement will trigger an automatic income tax liability for the employee each year, based on the P.S. 58 rates or the Insurer's Published Rates. In addition, in Technical Advice Memorandum 96-04-001,(44) the IRS indicated that under certain circumstances, with an "equity" arrangement, an employee will be required to include an additional amount in taxable income annually (namely, the annual increase in cash surrender value in excess of the premiums paid). There are several arguments that the TAM is incorrect, and these have been discussed in previous articles in this Journal,45 but it is important to consider the TAM. A related tax issue is the proper tax treatment for the employee (or his or her trust) when the split-dollar agreement terminates. The split-dollar agreement may terminate when the employee terminates employment or attains a certain age. At that point (frequently referred to as "roll out"), the company may be repaid for its premiums paid (under the "equity" approach), and the employee (or the employee's trust) becomes the sole owner of the policy. The principal issue is the taxation of the employee (or the trust) on any excess "equity" in the policy at the time the split-dollar agreement terminates.

There appears to be no direct authority on the conversion of one type of employee benefit for a split-dollar benefit. The closest case appears to be Martin v. Commissioner,46 in which several key management employees of Koch Industries, Inc. had deferred compensation plans that were created in the late 1960s and early 1970s. In 1981, employees were given an option of exchanging the benefits under these deferred compensation plans for benefits under a new "shadow" stock plan. Under the new plan, prior to retirement, the employees could elect to receive either (i) a lump sum payment at retirement or (ii) equal payments over 10 years. Several employees switched to the new plan, elected to receive payments over 10 years, and retired shortly after making the switch and the election. The IRS argued that those employees had constructively received the full amount of benefits under the new plan because they had an "unfettered right of choice" to receive the full lump sum distribution after switching to the new plan. However, the Tax Court disagreed with the IRS and held that the employees would not be taxed until they received the payments, stating that "there is no constructive receipt of income where an agreement under which the taxpayer would have received deferred payments from his employer was superseded by a bona fide later agreement."47 Thus, in Martin, the employer and the employees agreed to change the benefit program, and the employees could have received the cash benefits in a short period of time. Nevertheless, the court held that the employees were not taxable on the accrued benefit until actually receiving the cash payment.

A key issue would be whether the Martin court's approach would be applicable when the new plan is a split-dollar arrangement. The closest ruling appears to be Private Letter Ruling 6506169720A(48) in which the IRS considered some of the income tax consequences involved in an arrangement including a NQDC plan and a split-dollar benefit. In this private letter ruling, a nonprofit corporation allowed certain member-physicians to participate in a voluntary deferred compensation plan under which a physician could elect to defer from 10 to 30 percent of certain payments. About one-half of a physician's deferrals would be credited to an "insurance account" under an "investment fund" maintained by the corporation. "When the total amount credited to the insurance account is sufficient to purchase an ordinary life insurance policy on the member's life of not less than $5,000 in face amount, such a contract will be purchased on the 'split-dollar' basis." Although not entirely clear, it appears that the corporation would own the policy, and the physician could name the beneficiary of the insurance proceeds in excess of the guaranteed cash surrender value plus accumulated dividends. Future premiums would be paid by the corporation from the amounts deferred by the physician each year. Upon retirement, a physician would receive benefits based in part upon "the cash value, plus any additions or accumulations, of any life insurance policy on [the physician's life] ."49

The IRS reached three conclusions. First, until the life insurance policy is purchased, the physician will not be taxed on any of the amounts deferred under the voluntary deferred compensation plan. Second, when the corporation purchases the life insurance policy under the split-dollar arrangement, the physician will be taxed on the portion of the premium payments in excess of the cash surrender value of the policy (in column 5 of the table in Revenue Ruling 64-328, this amount represented $608.50 in the first year, $415.40 in the second year, and $209.50 in the

third year, when the total premium paid each year was $7,899.50) .50 Third, the physician will be taxed each year on the value of the current life insurance protection purchased. Revenue Ruling 66110(51) indicates that the value of the current life insurance protection for the employee in a split-dollar arrangement can be measured by the lower of (i) the P.S. 58 table amount or (ii) the Insurer's Published Rates.52 Thus, the "conversion" - in which an amount equal to part of the employee's NQDC balance was used to pay premiums on a life insurance policy subject to a split-dollar agreement in PLR 6506169720All does not appear to have triggered any tax liability for the employee in excess of the amount that would have been expected under Revenue Ruling 64-328.

Major tax advantages of a splitdollar arrangement are (i) that the death benefit is received income tax free54 and (ii) if the policy is owned from the outset by a properly structured irrevocable life insurance trust (ILIT) and the employee has no "incidents of **ownership**" in the policy, the death benefit may escape estate tax both on the death of the employee and on the death of the employee's surviving spouse.51

A conversion to split-dollar can trigger some of the negative consequences discussed above in connection with a conversion to a NQDC benefit. First, the employee will not have the luxury of receiving the full value of the benefit at any time he or she chooses. Second, under a split-dollar agreement, the corporation will need to pay the premiums (potentially reducing its available cash flow).

The potential features of the various available arrangements can be summarized in Table 2.

Legal Theories That May Cause Immediate Tax on the Built-In Gain Upon a Conversion or Change

There are several theories on which the built-in gain in a nonqualified stock option could be taxed immediately if it is converted into a **different type** of employee benefit or is otherwise amended. The theories include:

1. The constructive receipt doctrine;

2. The assignment of income doctrine;

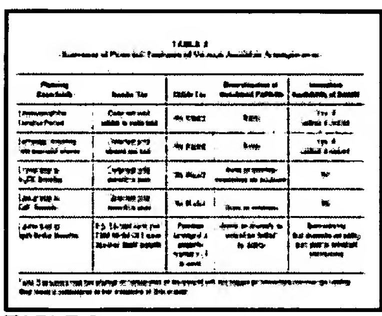

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TABLE 2

3. The economic benefit doctrine;

4. IRC Section 83; and

5. A taxable exchange under IRC Section 1001.

Constructive Receipt Doctrine

In the case of a cash-basis taxpayer, income is taxable in the year in which it is actually or constructively received.16 Code Section 1.451-2(a) of the Treasury Regulations provides that "Income... is constructively received... in the taxable year during which it is credited to [the taxpayer's] account or set apart for him so that he may draw upon it at any time." The IRS has stated "a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it.1117 In Revenue Ruling 60-31, the IRS stated that: "...the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment. It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it

appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice."58

Modification of an Existing Agreement

On several occasions, the IRS and the courts have considered situations in which compensation was deferred to a certain future date, and thereafter, but before the amount became payable, the employee and the employer agreed that the amount would be deferred for an even longer period of time. In general, the IRS has argued that an attempted "extension" is not effective, and the employee is taxed on the value of the accrued benefit at the time of the extension.19 In contrast, as discussed below, the courts generally have held that a modification before a benefit is payable does not create taxable income. Although the IRS has lost on this issue several times in court, it appears that the IRS will continue to litigate this issue and will refuse to issue advance rulings that such modifications will not trigger taxable income.

Court Cases Allowing Amendment of Agreements Without Triggering Constructive Receipt of Income

As described above, in Martin v. Commissioner,60 several key management employees were given an option to exchange nonqualified deferred compensation plan benefits for benefits under a new "shadow stock" plan. Some employees could switch to the new plan and receive a lump sum payment in a short period of time. Despite the IRS' attempt to tax the employees on the accrued but unpaid benefits; the Tax Court held that the employees who switched to the new plan and elected payments over 10 years would not be subject to income tax on the benefits until actually receiving the cash payments.

Similarly, in Veit v. Commissioner,61 Veit and his employer agreed at the beginning of 1939 that Veit would receive 10 percent of his employer's net profits for 1939 and 1940, as a compensation payment in 1941. In November of 1940, Veit and his employer entered into a new contract further deferring the payment of his share of the 1940 profits into 1942. The Tax Court concluded that Veit was not taxable on his share of the 1940 profits until they were actually received.

Also, in Oates v. Commissioner,61 Northwestern Mutual Life Insurance Company and many of its agents (including Oates) had entered into a contract in 1928 basically providing that for nine years after retirement, the agent would receive 712 percent of the renewal premiums on policies sold. Agents complained about these arrangements because the amounts paid usually declined each year (as policies were canceled), so that often the payments were reduced or disappeared as the retiree's need for the money was increasing. As a result, three days before his retirement, Oates and Northwestern Mutual amended the contract to provide that instead of the payments called for under the old contract, Oates would receive$ 1,000 a month for 180 months. The court concluded that Oates was only taxable on the amounts actually received ($1,000 per month), even though for the tax years at issue (1944, 1945, and 1946), Oates would have received much larger amounts under the old contract.63

In Veit v. Commissioner,64 (often referred to as "Veit 11"), the amount of the NQDC benefit was determinable before the bona fide amendment was made. In a two-year contract dated January 2, 1939, Veit and his employer agreed that Veit would receive 10 percent of the corporation's profits for 1939 and 1940. His share of the 1940 profits would be paid to him in quarterly installments in 1942. After the close of the 1940 year, the parties calculated that Veit's share of the profit for 1940 was $87,076. On December 26, 1941, the parties entered into a written contract in which they agreed that the $87,076 would be paid to Veit in five annual installments (and the unpaid balance would accrue interest until paid). The IRS argued that the entire $87,076 was taxable income to Veit in 1942 because it was "constructively received" by Veit in 1942.61 The IRS stressed that the amount payable to Veit had become ascertainable before the agreement to defer the payments was made and that the written contract was executed only five days before the end of the tax year. Nevertheless, the court emphasized the other changes in Veit's compensation package made with the changes to the NQDC payments and held that Veit would not be taxable on the benefits until he actually received the benefit payments. The court stated: "[The IRS] stresses that the amount of [Veit's] share... had been computed, credited on the corporate books, and the full amount deducted on the corporation's 1940 tax return [before the agreement to defer the payments was entered into]....We do not deem these differences material. Under existing contracts there was never a time when the $87,076.40 was unqualifiedly subject to [Veit's] demand or withdrawal. He did not voluntarily refrain from collecting money available to him, nor did he agree to the debtor's deferred payment of money available when the agreements were made."66

IRS Continues to Raise the Issue. Initially, it appeared that the IRS had conceded this issue. The IRS acquiesced in the first Veit case and in Oates.61 In discussing whether the IRS would argue that an amount cannot be deferred

after it is earned, the IRS stated in 1973 that "it is questionable whether the Service could defend such a position in litigation because of outstanding court cases."68

However, in Technical Advice Memorandum 86-32-003 the IRS indicated that an amount that has already been earned can only be deferred if there is a substantial risk of forfeiture for the employee. In TAM 86-32-003, the IRS considered the same facts as in the Martin case discussed above and stated, "As to amounts already earned and determinable, the subsequent and further deferral should not be recognized. The fact that amounts are not yet payable at the time of election is not a substantial restriction on the availability of the funds. In the ordinary situation, there is constructive receipt where the amounts are all payable currently. We believe that there should also be constructive receipt where the funds will be otherwise available after a short passage of time."61 The IRS distinguished Veit by saying that in Veit, (i) bilateral negotiations were conducted, and (ii) it appeared that the employer wanted to delay payment. As noted above, the IRS lost the Martin case when it was litigated. Although the courts have consistently rejected the IRS' arguments, it should be acknowledged that the IRS may continue to challenge taxpayers on this issue.

Assignment of Income Doctrine

The assignment of income doctrine is typically used by the IRS when a taxpayer attempts to assign income that has already been earned to another taxpayer (such as a family member), who may be at a lower marginal income tax rate than the donor.10 Presumably, an "assignment" to some other person or entity would be a prerequisite to applying the "assignment of income" doctrine. Based on this presumption, it would seem that if there is no transfer of funds to a third party (as in the case of a conversion from a NSO to a NQDC benefit), the assignment of income doctrine would not apply. Nevertheless, commentators have discussed the assignment of income doctrine in connection with the conversion of a NSO to a NQDC benefit."

Four IRS Rulings Applying the Assignment of Income Doctrine In a series of rulings, the IRS has used the assignment of income doctrine to tax the employee when funds were transfer-red to a third party in connection with an election to receive health insurance benefits (even though employees generally are not taxed on employer-provided health insurance benefits). In Private Letter Ruling 91 04-050,12 the employer maintained a health care fund, a pension plan, and a pension trust. Since many employees already had health insurance coverage (for example, because of a spouse's plan), the employees could elect to forego the health insurance, and instead the amount would be contributed to the employer's qualified plan.

The IRS held that employees who elect coverage under the health care fund would be taxed immediately as if the employee received a distribution from the qualified plan. The IRS stated: "When an employee has similar health and medical coverage under another plan but nevertheless elects to have contributions made to the Health Care Fund (by not demonstrating the existence of such similar coverage to the Health Care Fund's trustees), the employee is merely assigning future income (qualified plan distributions) for consideration (Health Care Fund benefits) and thus, is treated as currently receiving the future pension plan distributions for which the accident and health insurance coverage is a mere substitute. Because the receipt of pension plan distributions constitutes a taxable event, analogous to the situations in PG. Lake and Rev. Rul. 69-471, the employee has convertedfuture income into present income notwithstanding that the income may be used to purchase a nontaxable benefit" (emphasis added)."

Similarly, in Technical Advice Memorandum 94-06-002,14 the IRS held that employees would be taxed currently if they had the option of receiving either cash compensation or group health insurance coverage, even when the employees chose the group health insurance (the employer did not have a Section 125 Cafeteria Plan).

In Private Letter Ruling 94-05021,15 an employee could elect to have all or a portion of his or her elective deferrals allocated to a separate "retiree medical subaccount" rather than to the company profit sharing plan. At retirement, the employee could elect that those amounts would be used to pay health insurance premiums after retirement or to have those amounts distributed in accordance with the profit sharing plan. The company asked if amounts from the subaccount used to pay health insurance premiums would be excludable from income under IRC Section 106.16 The IRS concluded that amounts used to pay health care premiums would be included in the employee's gross income when paid to the third party (the health insurance company).

The most interesting ruling in this series is Private Letter Ruling 95-13027,17 in which the company maintained a profit-sharing plan that provided post-retirement medical benefits through a retirement health benefit account. An employee could elect each year to have a portion of the employer contributions made available for the payment of

post-retirement medical benefits. Upon retirement, the trustee applies amounts in the employee's health benefit account to the payment of health insurance premiums. The taxpayer asked whether the payment of health insurance premiums from the account would be excludable from the employee's gross income under IRC Section 106. The IRS concluded that the employee would be taxable immediately on any amounts contributed to the health benefit account, stating:

If an employee elects to have employer contributions made to his or her health benefit account where the option also exists to have those contributions made to his or her pension plan, the employee is foregoing the contributions to the pension plan. Contributions to a pension plan do not constitute a nontaxable benefit. The tax on the contributions is merely deferred until the amounts are distributed to the employee at a future date. Thus, when an employee elects to have those contributions made to the health benefit account, the employee is merely assigningfuture income (qualified plan distributions) for consideration (health contributions) and is treated as receiving the future pension plan distributions for which the contribution to the health benefit account is a mere substitute. Under the assignment of income doctrine, the contribution to the health benefit account is neither an excludable contribution to a health fund nor a tax deferred contribution to a 401(a) trust, but a taxable section 402 (a) qualified plan distribution. Because the receipt of a profit-sharing plan distribution constitutes a taxable event,... the employee has converted future income into present income when the health care account contributions are made, notwithstanding that the income may be used to purchase an otherwise nontaxable benefit.78

Thus, in a series of rulings, the IRS has consistently asserted that an election of benefits can trigger tax liability, even when the benefit received could have been obtained in a nontaxable manner.

Analysis of Assignment of Income Doctrine

If a **stock** option benefit is **converted** to a NQDC benefit or an SAR benefit (or if the exercise period of the option is merely extended), there is no transfer to a third party; presumably without a transfer to a third party, there is no "assignment," and the assignment of income doctrine would not apply (although it could be argued that PLR 95-13-02779 concludes that a taxable event occurred even though no amount was transferred to a third party).

In the case of a conversion to a split-dollar benefit, although funds are transferred to a third party (the insurer), the employer generally would be entitled to be repaid for the total amount transferred to the third party (namely, the premium payments or the cash surrender value).10 At the time of the "conversion," the employee likely would have no interest in the cash surrender value of the policy (because the premium paid would exceed the cash surrender value). If the split-dollar agreement terminated immediately after the conversion, the company could recover an amount equal to the premium paid, which likely would exceed the cash surrender value of the policy. The employee's only interest immediately after the conversion would be an interest in the death benefit in excess of the company's premium payment. Unlike the IRS rulings discussed above in which the employee derives the entire benefit from the health insurance, in the case of a split-dollar arrangement, the employee's benefit is limited to an interest in the excess death benefit (and the employee will be taxed on the value of that excess death benefit under the P.S.58 rates or the Insurer's Published Rates, under Revenue Ruling 66110).11 In future years, if the cash surrender value exceeds the premiums paid (and the amount repayable to the company), Technical Advice Memorandum 96-04-00112 would need to be considered. Thus, with a split-dollar arrangement, the employee is already taxed on the economic benefit provided to the employee.

"Economic Benefit" Doctrine

Of the various tests, often the most difficult to define and apply is the "economic benefit" doctrine. Like the "constructive receipt" doctrine, it is not directly set forth in the Internal Revenue Code.

The IRS has described the "economic benefit" theory as follows: "The principle generally known as the 'economic benefit' doctrine delimits one form of property, the fair market value of which must be included in gross income. Pursuant to this theory, the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A 'fund' is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in such a fund is 'vested.' The crux of the theory is that an amount must be paid out or set aside irrevocably for the benefit of the employee. That is, the amount is funded."83

The "economic benefit" doctrine is fundamentally different from the "constructive receipt" doctrine. The "constructive receipt" doctrine analysis begins after it has been determined that the amount or benefit has not actually been "received." In contrast, the "economic benefit" doctrine considers whether the employee has received

such **ownership** and/or other "economic benefits" in the subject property that the employee should be taxed on the amounts.

In Minor v. United States, 14 a physician participated in a voluntary deferred compensation plan established by his employer. For certain periods, the physician deferred 90 percent of his scheduled fees. The employer established a trust with three physicians, including the taxpayer, as the trustees. The trust purchased "retirement annuity policies" to provide for the payment of benefits under the plan. The court stated that "[tihe economic benefit doctrine is applicable only if the employer's promise is capable of valuation," and "[a] current economic benefit is capable of valuation where the employer makes a contribution to an employee's deferred compensation plan that is (i) nonforfeitable, (ii) fully vested in the employee; and (iii) secured against the employer @ creditors by a trust arrangement."" Since the trust assets were subject to the claims of the company's creditors in Minor, the court concluded that the economic benefit doctrine did not apply.

If a nonqualified **stock** option benefit is **converted** to a split-dollar benefit, the employee receives an economic benefit. In Revenue Ruling 64-328, the IRS concluded that the "economic benefit" received by an employee under a split-dollar agreement is the value of the term insurance benefit provided.116 In Revenue Ruling 66-110, the IRS held that the "economic benefit" can be measured by the P.S. 58 rates, or if lower, the Insurer's Published Rates." Thus, the IRS has defined the amount of the "economic benefit" when the employee is a party to a split-dollar arrangement.

IRC Section 83

Section 83 of the Internal Revenue Code provides that if an employer transfers "property" to a person in connection with the performance of services, the person providing the services and receiving the property must include the fair market value of the property in gross income for the first taxable year in which the service provider's rights to such property are either (i) transferable or (ii) not subject to a substantial risk of forfeiture."

In regards to a "conversion" to NQDC benefits, generally Code Section 83 will not apply when a NQDC arrangement is established because there is no transfer of "property." The applicable regulations provide that "the term 'property' includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."89 Thus, the benefits accrued under a NQDC arrangement will not be taxable to the employee under Code Section 83 (until actually paid to the employee) as long as the NQDC arrangement is merely an "unfunded and unsecured" promise to pay money in the future.

In regards to a conversion to a split-dollar benefit, except for TAM 96-04-00190 (discussed earlier in this article), normally IRC Section 83 has not been applied to split-dollar arrangements. While two other splitdollar letter rulings" discussed IRC Section 83, that section was only considered in connection with the termination of the split-dollar arrangement - not in connection with the creation or maintenance of the split-dollar arrangement. Traditionally, an employee has been taxed each year on the "economic benefit" provided under a split-dollar agreement.91 IRC Section 83 may not he applicable during the term of a split-dollar arrangement because there is no annual "transfer of property" to the employee.93 In addition, Treasury Regulation Section 1.83-3(e) can be read to imply that only the cash surrender value of a life insurance policy is considered to be "property." In a typical split-dollar arrangement, neither the employee nor the employee's trust would have any interest in the policy's cash surrender value for many years (until the cash surrender value exceeds the premiums paid).

Argument that a Taxable Exchange Occurs Under IRC Section 1001

IRC Section 1001(a) states that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis...." In order to apply IRC Section 1001(a), it is necessary to consider whether either the benefit surrendered, or the benefit received, is "property.1114 In Revenue Ruling 98-21,11 the IRS considered whether a stock option is "property" for federal gift tax purposes. The IRS concluded that a completed gift could occur at the later of (i) the date of the transaction or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor. Based on Revenue Ruling 98-21, if the stock option is vested and exercisable, the stock option would constitute "property" (at least for gift tax purposes).

In regards to a "**conversion**" of **stock** option benefits to NQDC benefits, prior to the enactment of IRC Section 83 in 1969, it had been held that when property was given in exchange for services rendered, IRC Section 1001 could apply because the services rendered could be characterized as "money's worth.1196 However, Section 83 now

governs the tax consequences when "property" is transferred to an employee for services rendered. A NQDC benefit normally is structured as an unfunded and unsecured promise to pay money or property in the future. For purposes of Section 83, an unfunded and unsecured promise to pay money or property in the future is not "property."97 Thus, it appears that a typical NQDC benefit is not "property;" therefore, IRC Section 1001 should not apply to a **conversion** of **stock** options for NQDC benefits.

In regards to a "conversion" to split-dollar benefits, Revenue Ruling 64-32891 states that the employee under a split-dollar arrangement recognizes taxable income to the extent of the "economic benefit" under IRC Section 6119 (in an "employer-pay-all" arrangement). This "economic benefit" measures the term insurance benefit provided, and the IRS has ruled that the payment of term insurance benefits does not generate a tax basis in property. 100 Thus, it can be argued that the "economic benefit" under Revenue Ruling 64-328 is not "property." As discussed above, TAM 9604-001 101 indicates that an additional amount may be taxable to the employee each year under IRC Section 83. However, at the time of the benefit conversion, the rationale of TAM 96-04-001 likely would not be applicable (because at that time the employer would be entitled to be repaid for the full amount of its premium payment, and the cash surrender value would not exceed the premium paid).

Securities Issues in Connection with a Benefit Exchange

The SEC rules for disclosure of employee and director compensation were substantially revised in 1992. The rules provide for a "Summary Compensation Table" designed to set forth the compensation for the organization's top executives for the last three years in an easy-to-read format."" In addition to the Summary Compensation Table, other compensation information must be provided in related tables and notes. In regards to directors, the company is required to disclose "any standard or nonstandard compensation arrangement.. in textual narrative... stating the specific amounts paid."103

Disclosure of Executive Compensation in General

The Summary Compensation Table provides compensation information for up to five individuals - the organization's chief executive officer (regardless of his or her level of compensation) and the four highest paid individuals for the last completed fiscal year (based on salary and bonus), whose salary and bonus exceed $100,000.104 A Summary Compensation Table can have seven columns - three for "Annual Compensation," three for "Long-Term Compensation," and one for "All Other Compensation." The compensation information for the CEO and the four highest paid other executives are disclosed in these seven columns or in the supplementary tables or notes to the Summary Compensation Table.

Scope of Rules

The rules adopted in 1992 apply to proxy statements, information statements, registration statements, and periodic reports under the Securities and Exchange Act of 1934, and apply to registration statements filed under the Securities Act of 1933.105 Thus, the Summary Compensation Table (and the other information required by the 1992 rules) will be included in the proxy statements sent every year to the shareholders of the corporation (for the election of directors and any other transactions requiring shareholder approval).

Reporting of Stock Options

The Summary Compensation Table includes a column for the number of stock options. In addition, a separate table for "Option/SAR Grants in Last Fiscal Year" and a separate table for "Aggregated Option/SAR Exercises in Last Fiscal Year and FY-End Option/SAR Values" are required. 101 The later table includes a column titled "value of unexercised in-the-money options/SARs at FY-end ($) exercisable/unexercisable."

If a **stock** option is **"converted"** into another type of employee benefit, this conversion will impact the amounts reported for the executive; the "value of unexercised in-the-money options" will decrease. In addition, if the NSO is replaced with a NQDC benefit or a split-dollar benefit, the new benefit will need to be reported.

Reporting Nonqualified Deferred Compensation Benefits

The method of reporting a NQDC benefit depends on whether a defined contribution-type arrangement, or a defined benefit-type arrangement, is used. If a defined benefit-type plan is used, the benefits are not included in the

Summary Compensation Table. 101 Instead the benefits would be reported in a separate "pension table."101

A defined contribution-type NQDC plan might be particularly appropriate when **stock** options are **converted** because the executive's initial "deferred compensation account balance" could equal the built-in gain in the NSO. The "company contributions" would be reported in the "All Other Compensation" column of the Summary Compensation Table. 101

If the NQDC plan provides for interest to accrue on the contributions and the interest rate exceeds 120 percent of the applicable federal rate, the excess will be included in the "All Other Compensation" column.110 Also, in the case of "dividends (and dividend equivalents)" only the "preferential" portion need be included in the "All Other Compensation" column, and such amounts are preferential "only if earned at a rate higher than dividends on the registrant's common stock."" I Presumably, if the amount of "dividends" added to the employee's NQDC account are based on a designated mutual fund, or on other stocks that are designated, the amounts would not be considered "preferential."

Thus, in the case of a defined contribution-type plan, all of the benefits that accrue during the year (except for interest up to 120 percent of the applicable federal rate and dividends not in excess of a "preferential" amount) will be reported in the Summary Compensation Table, even though the employee may not receive the cash benefits for many years. Reporting of

Split-Dollar Arrangements

If the NSOs are "converted" to split-dollar benefits, the split-dollar benefits will need to be reported. The preamble to the 1992 rules states: "As adopted, the portion of the premium paid by the registrant in the covered fiscal year pursuant to a split-dollar arrangement that is attributable to term life insurance coverage for the executive officer will continue to be reported in full [the notes indicate that this amount is the taxable economic benefit to the employee].... Registrants will be given the option of reporting either: (1) The full dollar value of the remainder of the premiums paid by or on behalf of the registrant during the covered fiscal year; or (2) the current dollar value of the benefit to the executive officer of the remainder of the premium paid by or on behalf of the registrant during the fiscal year. The benefit must be determined for the period, projected on an actuarial basis, between the payment of the premium and its refund at the earliest possible time to the registrant."112

Thus, it is clear that in an "employer-pay-all" split-dollar arrangement, the "economic benefit" amount taken into taxable income by the employee - the value of the term insurance benefit provided to the employee - must be reported. In addition, the preamble, as well as the regulation,"' indicates that an additional amount must be reported. The company is given the option of reporting the entire premium payment, but this would seem to be an excessive amount since the employer eventually will be repaid for its premium payments (or will receive the cash surrender value of the policy, under Revenue Ruling 64328). Alternatively, the employer can report a lesser amount - "the current dollar value of the benefit to the executive officer of the remainder of the premium paid by or on behalf of the registrant during the fiscal year. The benefit must be determined for the period, projected on an actuarial basis, between payment of the premium and its refund at the earliest possible time to the registrant." 114 Although not entirely clear, in the case of an "equity" split-dollar arrangement (in which the employer is simply repaid for its premiums upon the termination of the agreement or the employee's death), this may require the calculation of an "interest" amount. Thus, although the IRS specifically rejected the theory that a split-dollar arrangement creates an interest-free loan in Revenue Ruling 64-328, the SEC reporting rules can require the calculation of an interest factor. Nevertheless, if the corporation can terminate the split-dollar agreement at any time under the terms of the split-dollar agreement, it would appear that no additional amount would need to be reported because the calculation is made assuming that the refund is made at the "earliest possible time." The split-dollar portion is reported under the "All Other Compensation" column. 115

Additional Rules Regarding Stock Options

One commentator has stated "All exercises of [NSOs] by an executive who is subject to the executive compensation proxy disclosure rules must be reported, even if the delivery of the shares acquired upon the exercise is deferred," and even if "the election to defer is reported on Form 5."111 Depending on how the benefit exchange transaction is structured, there may be issues as to whether the stock options were actually "exercised," deferred, or simply replaced.

In the case of stock options issued by publicly traded companies, the short-swing profit recovery rules of Sections

16(a) and 16(b) of the 1934 Act apply to the grant and exercise of options, unless an exemption applies. 117 These rules prohibit certain short-swing transactions by insiders, by regulating sales and purchases of employer securities that occur within 6 months of each other."' Thus, an issue is whether an exchange of the stock option for a **different type** of benefit would be deemed to be an "exercise" of the option followed by an immediate sale of the stock and whether it was made within the restricted period of time. Presumably as a result of this issue, one commentator has suggested exchanging the NSOs for benefits under a nonqualified deferred compensation plan (which presumably initially provides for benefits to be paid in company stock only), and then waiting at least six months before amending the nonqualified deferred compensation plan to permit payment in assets other than company stock."19

Form 10-K Filing

Item 14 of Form 10-K requires an "annual listing of all employee compensation plans required to be filed as exhibits to the Form, identifying the Commission filing to which a particular plan document has been appended."120 One commentator has stated, "If the company is a reporting company under the '34 Act, it should consider filing the NQDC plan and/or the amended stock option plan as an exhibit to the annual report filed on Form 10-K."121 Presumably, such a filing also should be considered if the benefit is exchanged for a split-dollar benefit or any other type of benefit.

Accounting Issues in Connection with a Benefit Exchange

There can be significant differences of opinion over the proper accounting treatment of employee benefit arrangements. The client will want to obtain the opinion of the responsible accountants in the particular situation.

An understanding of some of the basic financial accounting authorities can be helpful in analyzing an arrangement with the client and the other professionals involved. Sometimes the potential impact of a benefit arrangement on the employer's financial statements can be a factor in deciding whether to adopt a benefit arrangement. For example, a switch from stock option benefits to NQDC benefits may force the company to record a significant expense item that may significantly reduce earnings per share. If a significant drop in earnings per share would have negative consequences, such as reducing the potential sale price of the company, the company may veto the employee's request to **convert stock** option benefits to NQDC benefits.

Accounting for Stock Options in General

Commentators have stated that the accounting treatment of stock options is very favorable - many argue that the treatment is too favorable! If a company issues a stock option with a strike price equal to the current market value, the company is not required to record an expense.122 This is frequently referred to as "fixed accounting" for stock options (and is only available if the number of shares and the option price are "fixed"). Thus, in a typical situation, the company is not required to record an expense when the option is issued or as the value of the stock increases (which increases the "built-in gain" for the options). In 1995, this issue was examined and companies were required to disclose the "pro fon-na" effect of stock options on earnings in a footnote - not in the actual financial statements."' In regards to the favorable accounting treatment, "accounting analysts estimate that option grants issued by hightech companies in 1997 would have slashed net income at those companies anywhere from 10 percent to 100 percent, if they were expensed."114

Accounting for Extension of a Stock Option

The extension of the exercise date of an option will require the corporation to recognize compensation expense, on the date of the extension, to the extent that the fair market value of the stock exceeds the exercise price under the option (reduced by any compensation expense recorded when the option was originally granted). I" The following example generally illustrates this type of extension:

XYZ Company issues a stock option to Executive A on 1/l/99 with a strike price of $ 10 per share when the fair market value of XYZ Company stock is $ 10. The option must be exercised within 10 years of issuance. Under APB Opinion No. 25, no expense would be recorded on the financial statements for the issuance of the options. On 10/31/2008, when the fair market value of the stock has risen to $25 per share, XYZ Company and Executive A agree to extend the exercise period to 10/31/2015. XYZ Company would be required to record compensation expense of $15 per share on its financial statements. This could significantly depress XYZ Company's eamings for the period including 10/31/2008.

Accounting for the Exercise of NSOs Using "Old and Cold" Shares

The Financial Accounting Standards Board's (FASB) Emerging Issues Task Force addressed this issue and basically concluded that if the "old and cold" shares had been held by the employee for the necessary holding period, it would not be necessary for the corporation to recognize compensation expense at the time of the exchange.126

Accounting for Nonqualified Deferred Compensation Benefits and SAR Benefits

If the **stock** options are **converted** into NQDC benefits by establishing a "defined contribution" type NQDC plan and crediting the employee with an initial "deferred account balance" equal to the built-in gain of the stock options, and if the NQDC benefit would be payable in cash, the company would record an expense equal to the amount of the built-in gain. 127 "Defined benefit" type NQDC plans are subject to other accounting rules. 121 Thus, the conversion to a NQDC benefit can create a significant expense on the company's financial statements, thereby depressing earnings. Commentators have argued that based on the rationale for not recording compensation expense when NSOs are exercised using "old and cold" shares, no compensation expense need be recorded if the NQDC benefit is payable solely in company stock. 129

In contrast to the "fixed accounting" treatment generally available to stock options, SARs generally are subject to "variable accounting," which requires the employer to "measure compensation as the amount by which the quoted market value of the ... stock... exceeds the option price or value specified...," and the expense is accrued over the period the employee performs the services. 110

Accounting for Split-Dollar Benefits

In the mid-1980s, in response to changes in life insurance policy design and features, the accounting industry reconsidered the rules for business-owned life insurance. On October 31, 1984, a committee of the ⓘAmerican Institute of Certified Public Accountants (ⓘAICPA) published an "Issues Paper" on the subject, and in response to that report, the Financial Accounting Standards Board (FASB) issued Technical Bulletin 854. The Technical Bulletin basically concludes that in recording a life insurance policy as an asset on the entity's balance sheet, the policy should be reported at its cash surrender value regardless of the special features or riders included with the policy, and regardless of whether the entity is "economically or contractually committed" to premiums in the future. 131

While "split-dollar" is not specifically mentioned in FASB Technical Bulletin 85-4, it is discussed in the "Issues Paper."131 The Issues Paper describes split-dollar arrangements in which the entity is only repaid for its premiums (often referred to as "equity" split-dollar) and arrangements in which the entity receives an amount equal to the entire cash surrender value of the policy. The Issues Paper states that "differences between periodic premiums and increases in cash surrender value are to be charged or credited to earnings."133

Based on the Issues Paper and Technical Bulletin 85-4, when a splitdollar arrangement is established and the entity is entitled to be repaid for its premiums, the payment of each premium by the entity would create an asset (equal to the lesser of the policy cash surrender value and premiums paid - assuming the corporation would be entitled to the lesser of those two amounts under the splitdollar plan), and the excess of premiums paid over cash surrender value would be recorded as an expense. As the annual increase in cash surrender value rises over time, the amount of expense recorded each year would decrease, and when the annual increase in cash surrender value exceeds premiums paid, the entity would record a revenue item (until cash surrender value equals total premiums paid, at which time the total expense and total revenue recorded would be equal). If at the time the split-dollar benefit is established, the entity's obligation to pay future premiums is contingent on the employee's obligation to provide future services, it seems unlikely that the entity would be obligated to record an expense (or a liability) for the future premiums that might need to be paid. Instead, the only expense that would need to be recorded would be for the excess of the premium paid over the growth in the policy's cash surrender value. A more difficult issue is whether the obligation to pay future premiums must be recorded as an expense (and a liability) if the entity is required to pay over a fixed number of years, even if the employee terminates employment. Since Technical Bulletin 85-4 states that the insurance asset cannot be valued on the assumption that future premiums will be paid (even if the entity is contractually obligated to pay those premiums), 114 it might be argued that the corresponding liability (or expense) also should not be recorded.

The next issue is whether any additional expense must be recorded if rather than simply establishing a new split-dollar arrangement, the parties are **converting** a **stock** option arrangement into a split-dollar arrangement. An

Exposure Draft from the Financial Accounting Standards Board states: "For transactions that involve the cancellation of an option or award in connection with the issuance of a **different type** of award (for example, the cancellation of an option in connection with the issuance of restricted stock), additional compensation cost is recognized to the extent that the intrinsic value of the new award exceeds the intrinsic value of the original award at the new measurement date."135

"Intrinsic value" has been defined as "the difference between the market value per share and the exercise price." 116 Note that the Exposure Draft compares the value of the new award to the value of the original award "at the new measurement date," rather than the intrinsic value of the old stock option when it was originally granted. The following example generally illustrates the Exposure-Draft comparison:

XYZ Company issues a stock option to Executive A on I/ 1 /99 with a strike price of $ 10 per share when the fair market value of XYZ Company stock is $ 10 per share. The option must be exercised within 10 years of issuance. On 10/31/2008, when the fair market value of the stock has risen to $25 per share, XYZ Company and Executive A agree to replace the NSOs with split-dollar benefits. Assuming the projected benefit to Executive A under the split-dollar agreement has the same value on 10/31/2008 as the value of the NSO benefit, the Exposure Draft suggests that no additional compensation expense would be recorded on the financial statements. However, if the value of the split-dollar benefit exceeds the value of the NSO benefit, the Exposure Draft indicates that additional compensation expense should be recorded.

Conclusion

Income and estate taxes can eliminate a substantial portion of the value of nonqualified stock option benefits. If the company and the employee desire to defer the payment of the benefit (and the employee's income tax on the benefit) for a period of years, a number of alternatives are available, including extending the exercise period, exercising the option with "old and cold shares," or converting the NSO benefits to nonqualified deferred compensation benefits or stock appreciation rights. In addition, if the employee will not need the wealth from the NSO and desires to pass it along to the next generation, the company and the employee may want to convert the NSO benefits into splitdollar benefits. J

(I/R Code No. 2400.00/2600.04)

[Sidebar]
This issue of the Journal went to press in February 2000.

[Footnote]
(1) See Mark A. Teitelbaum, Planning with Executive Stock Options: Maximizing Dollars for Investment While Minimizing Taxes, 52 J. Am. Soc'y of CLU & ChFC, 36, 55 n. 1-5 (March, 1998); Work Week, Wall St. J., June 10, 1997, at A- I (referring to a KPMG survey indicating that high-tech firms use employee stock options more than other firms).
(2) I.R.C. 162(m)(4)(C)(1993).
(3) Norma M. Sharara, Stock Option Plans Paired with Non-Qualified Deferred Compen

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sation Plans: A Fact of Life or a Passing Fad?, 39 Tax Mgm't Memo 423 (1998).
(4) Adam Bryant, They're Rich (And You're Not), Newsweek, 36, 38 (July 5, 1999).
(5) Teitelbaum, supra note 1.
(6) Stock acquired by the executive under a qualified option normally will be held for at least a year. See I.R.C. 422(a)(1). If the stock is not held for the requisite one-year period, the employee will be taxed at ordinary income tax rates on the gain from the sale. I.R.C. 421(b). See William F. Sweetnam, Statutory Stock Options, 381 Tax Mgm't (BNA), A-7 & A-8.

[Footnote]
(7) If an NSO has a "readily ascertainable value" at the time of grant and is "in the money," the employee receiving the stock option would be required to include an amount in taxable income at the time of grant. See John L. Utz, Nonstatutory Stock Options, 383-2nd Tax Mgm't (BNA), at A- 13. For example, if the stock option has a "readily ascertainable value" and the strike price is $8 and the fair market value is $ 10, the employee would be obligated to include $2 for each share (that could be acquired under the option) in his or her taxable income in the year of the grant. An option will have a "readily ascertainable value" if it is actively traded on an established market. If the option is not actively traded on an established market, it will not have a "readily ascertainable value" unless four conditions are met. Id. at 1.83-7(b)(1), (2). In general, these tests "make it difficult to establish readily ascertainable fair market value at grant...." John L. Utz, supra at A-5. Throughout the remainder of this article, it will be assumed that the NSO does not have a "readily ascertainable value" at grant.

[Footnote]
(8) John L. Utz, Nonstatutory Stock Options, 383-2nd Tax Mgm't (BNA), at A-15.
(9) States with high maximum marginal personal income tax rates include North Dakota (12 percent), Montana (11 percent less $1,971), Hawaii (10 percent), California (9.3 percent), Oregon (9 percent), and Iowa (8.98 percent). All St. Tax Guide (CCH) (2d ed), 115,000. States with no income tax include: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. See H.R. Rep. No. 104-389 (1995), reprinted in 2 U.S. Code Cong. & Admin. News, 1995, at 1006, 1008 n.6 (1995).
(10) Proposed Treasury Regulations published in 1994 indicated that if an employer failed to withhold income taxes on an amount taxable to the employee under I.R.C. 83, the employer would not be entitled to an income deduction under I.R.C. 83(h). In 1995, the proposed Treasury Regulations were amended to delete this po

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tential penalty for failing to withhold. T.D. 8599, 1995-2 C.B. 12; See Treas. Reg. 1.83-6.
(11) See John L. Utz, supra note 8, at A-37 & A-38. (12) The maximum exercise period for a qualified stock option is 10 years. I.R.C. 422(b)(3). Although there is no similar rule for NSOs, the exercise period for an NSO often is set at 10 years as well because NSOs and QSOs frequently are issued simultaneously under the same plan document, and the plan will provide that the maximum possible amount of options will be treated as QSOs, and the remaining options issued will be treated as NSOs.
(13) However, there has been a great deal of interest in attempting to transfer the built-in gain in stock options to other family members. See Rev. Rul. 98-21,1998-18 IRB 7; Rev. Proc. 9834, 1998-18 IRB 15. See also Priv. Ltr. Rul. 9722-022 (Feb. 27, 1997); 96-16-035 (Jan. 23, 1996); 95-14-017 (Jan. 9, 1995).
(14) I.R.C. 422(b)(3).

[Footnote]
(15) However, if the exercise period of a stock option is so long that exercise could be deferred until the employee's retirement, there is a risk that the arrangement could be a "pension plan" under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and be subject to various ERISA requirements.
(16) Priv. Ltr. Rul. 94-31-021 (May 6, 1994). (17) John L. Utz, supra note 8, at A-15.
(18) 1980-2 C.B. 235.
(19) I.R.C. 422(d) (the value of shares of employer stock that can be exercised for the first time in any one year under QSOs cannot exceed $ 100,000 based on the fair market value of the stock at the date of the grant). In the case of a QSO, the exercise price cannot be lower than the fair market value of the stock on the date of the grant. I.R.C. 422(b)(4).
(20) I.R.C. 10 14.
(21) Priv. Ltr. Rul. 99-01-066 (Sept. 28, 1998). (22) I.R.C. 61100)(3).

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(23) An employee would be deemed to have retired: (i) upon terminating employment on or after age 65; (ii) upon terminating employment on or after the date on which the sum of the employee's age and years of service equal 75; or (iii) at a time specifically approved by the board of directors of the parent corporation.
(24) Presumably the ruling mentions that none of the employees were controlling shareholders because of the IRS' negative view on NQDC for controlling shareholders. See Tech. Adv. Mem. 88-28-004 (April 12, 1988) (concluding that a controlling shareholder would be taxed immediately on the deferred amounts); Rev. Proc. 96-3, 1996-1 C.B. 456, 461, 3 (30) (IRS refuses to

[Footnote]
issue advance rulings on NQDC arrangements for controlling shareholders).
(25) Although the ruling refers to an amount and also indicates that the Subsidiary created a rabbi trust under which Subsidiary may direct the investment of trust assets, the ruling does not state whether the benefit is payable in cash or company stock, and it does not state whether "earnings" will be credited to the employee's account balance. (26) The IRS has concluded in several situations that the existence of a "change of control" provision in a nonqualified deferred compensation arrangement will not trigger immediate tax for the employee. See Priv. Ltr. Rul. 95-08-014 (Nov. 22, 1994); Priv. Ltr. Rul. 92-04-012 (Oct. 23, 1991); Priv. Dr. Rul. 87-46-052 (Aug. 19, 1987) (amounts are paid after an involuntary termination following a change of control); Priv. Ltr. Rul. 84-18-095 (Jan. 31, 1984) (deferred amounts become immediately payable upon a change of control).
(27) Supra note 21.

[Footnote]
(28) The IRS has ruled that an employee can have the right to designate investments, and the growth of the employee's nonqualified deferred compensation balance may be measured by the growth of the designated investments, provided that the employer is not obligated to actually acquire any designated investment. In addition, if the employer actually acquires a designated investment, the employee cannot have any special rights in such assets (the employee must have only the rights of an unsecured general creditor in seeking to collect benefits under the nonqualified deferred compensation plan). Priv. Ltr. Rul. 95-05-012 (No@. 4. 1994).

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(29) See Rev. Rut. 60-31, 1960-1 C.B. 174, modified by Rev. Rut. 64-279, 1964-2 C. B. 121, and Rev. Rut. 70-435, 1970-2

C.B. 100. If the employee had the right to immediately demand payment of the nonqualified deferred compensation benefits, the employee would be in constructive receipt of the benefits, and would be taxed on those benefits immediately. Treas. Reg. 1.451-2(a). (30) See Veit v. Commissioner, 8 T.C. 809 (1947), acq. 1947-2 C.B. 4; Oates v. Commissioner, 18 T.C. 570 (1952), aff'd 207 F.2d 711 (7th Cit. 1953), acq. 1960-1 C.B. 5: Martin v. Commissioner, 96 T.C. 814 (1991).
(31) ERISA 201(2), 301(a)(3),401(a)(1); 29 U.S.C. 1051(2), 1081(a)(3), I 101(a)(1). (32) These comments normally are based on DOL Advisory Opinion 75-64 (Aug. 1, 1975), in which the DOL stated that a plan covering fewer than 4 percent of active employees qualified as a top hat plan. See Michael G. Goldstein, et al., Taxation and Funding of Non qualified De

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ferred Compensation - A Complete Guide to Design and Implementation, 135-136 (1998) (part of the Insurance Counselor Series published by the Real Property, Probate and Trust Law Section of the American Bar Association). (33) Rev. Proc. 71-19, 1971-1 C.B. 698, as amplified by Rev. Proc. 92-65, 1992-2 C.B. 428 (the employee will have only the rights of a general unsecured creditor under a NQDC plan). (34) For a general discussion of SAR plans, see Neal A. Mancoff & David M. Weiner, Nonqualified Deferred Compensation Arrangements, 5.01 (1998).
(35) Rev. Rul. 80-300,1980-2 C.B. 165. (36)Treas. Reg. 1.451-2(a) ("income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations of restrictions").
(37) Priv. Ltr. Rul. 88-29-070 (April 27, 1988). (38) Supra note 35.

[Footnote]
(39) See Frank L. Rainaldi, Split-Dollar Rollout Via Deferred Gift to a Grantor Life Insurance Trust, 53 J. of Financial Service Professionals, 60 (July, 1999); Michael G. Goldstein & William A. Drennan, Financing a SERP and Split Dollar Plan with a Single Policy, 51 J. of Amer. Soc'y of CLU & ChFC 34 (Jan. 1997); W. Patrick Cunningham, The Taxation of Equity Split Dollar Plans, 51 J. of Amer. Soc'y of CLU & ChFC, 67 (Jan. 1997); Herbert Chasman, Equity Split Dollar Life Insurance Under Attack by IRS, 50 J. of Amer. Soc'y of CLU & ChFC, 76 (Nov. 1996). (40) Rev. Rul. 64-328, 1964-2 C.B. 11.
(41) Rev. Rul. 66-110,1966-1 C.B. 12,14. (42) Rev. Rul. 64-328, 1964-2 C.13 at 12.
(43) See Tech. Adv. Mem. 96-04-001 (Sept. 8, 1995).
(44) Id.

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(45) Supra note 39.
(46) Martin v. Commissioner, 96 T.C. 814 (1991).
(47) Id. at 824.
(48) Priv. Ltr. Rul. 6506169720A (June 16, 1965). (49) Id.
(50) Supra note 40. (51) Supra note 41. (52) Id.
(53) Supra note 48.

[Footnote]
(54) Rev. Rul. 64-328, 1964-2 C.B. 15 ("It is further held that the provisions of section 101 (a) of the Code apply to the proceeds of the policy payable on the death of [the employee], both as to the portion received by [the corporation] and as to the portion received by the designated beneficiary of [the employee]").
(55) Michael G. Goldstein & William A. Drennan, supra note 39, 51 J. of Amer. Soc'y of CLU

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& ChFC 34 (Jan. 1997).
(56) Treas. Reg. 1.451 -1 (a); 1.446-1 (c)(1)(i). (57) Rev. Rul. 60-31, supra note 29.
(58) Id. at 178.
(59) Rev. Proc. 71-19, supra note 33; Tech. Adv. Mem. 86-32-003 (April 18, 1986).
(60) Supra note 46.
(61) Veit v. Commisssioner, 8 T.C. 809 (1947). (62) Oates v. Commissioner, 18 T.C. 570 (1952), aff'd 207 F.2d 711 (7th Cir. 1953).
(63) See also Kimbell v. Commissioner, 41 B.T.A. 940 (1940) ("If the parties had a fight to make the first oral agreement, they had a fight to make the second, and our only concern is whether these agreements actually existed and were intended as real, genuine, bona fide agreements between the parties.")
(64) 8 T.C.M. 919 (1949). (65) Id. at 922.
(66) Id. at 920.

[Footnote]
(67) 1947-2 C.B. 4 (Veit); 1960-1 C.B. 5 (Oates). (68) Gen. Couns. Mem. 35, 196 (Jan. 16, 1973) (citing Veit and Oates).
(69) Tech. Adv. Mem. 86-32-003 (April 18,1986). (70) Boris L. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, 175.1, (2d ed. 1991).
(71) A. Thomas Brisendine, Deferring Tax on Gain from Stock Option Exercise: Does it Work?, 10 Ben. L. J. 121, 131 (Summer, 1997); See also Sharara, supra note 3.
(72) Priv. Ltr. Rul. 91-04-050 (Nov. 1, 1990). (73) Id.
(74) Tech. Adv. Mem. 94-06-002 (Oct. 27,1993). (75) Priv. Ltr. Rul. 94-05-021 (Nov. 8,1993). (76) I.R.C. 106.
(77) Priv. Ltr. Rul. 95-13-027 (Jan. 4, 1995). (78) Id.

(79) Id.

[Footnote]
(80) Rev. Rut. 64-328,1964-2 C.B. 11, 12; Tech. Adv. Mem. 96-04-001 (Sept. 8, 1995).
(81) Supra note 52. (82) Supra note 43.
(83) Gen. Couns. Mem. 35, 196 (Jan. 16, 1973) (emphasis added).
(84) Minor v. United States,772 F.2d 1472 (9th Cir. 1985).
(85) Id. at 1474 (emphasis added).
(86) Rev. Rut. 64-328, 1964-2 C.B. at 13. (87) Rev. Rut. 66-110,1966-1 C.B. 12, 14. (88) I.R.C. 83(a).
(89) Treas. Reg. 1.83-3(e) (emphasis added). (90) Supra note 43.
(91) Priv. Ltr. Rut. 79-16-029 (Jan. 17, 1979); and Priv. Ltr. Rut. 83-10-027 (Dec. 3, 1982). (92) Supra note 45.
(93) Treas. Reg. 1.83-3(e) states that "in the

[Footnote]
case of a transfer of a life insurance contract... only the cash surrender value of the contract is considered to be property" (emphasis added). Since there is no transfer of an entire contract, this provision may not apply.
(94) I.R.C. 1001(a).
(95) Rev. Rul. 98-21, 1998-18 I.R.B. 7.
(96) See International Freight Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943).
(97) Treas. Reg. 1.83-3(e). (98) Supra note 40.
(99) I.R.C. 61.
(100) Priv. Ltr. Rul. 94-43-020 (July 22, 1994) (concluding that the portion of the premiums paid by an insured for the term insurance benefit provided under a whole life policy did not increase the insured's tax basis).
(101) Supra note 43.
(102) SEC Release No. 33-6962, Securities Exchange Commission - Final Regulations on Executive Compensation Disclosure, revised item 402 of Regulation S-K, 57 Fed. Reg. 48126

[Footnote]
(Oct. 21, 1992). (103) Id. at 48137. (104) Id. at 48129. (105) Id. at 48126.
(106) Id. at 4813448135. (107) Id. at 48137.
(108) Id. (emphasis added) (109) Id. at 48133.
(110) Id. at 4813 1; 17 C.F.R. 229.402(b) (Instructions to Item 402(b)(2)(iii)(Q.
(111) 17 C.F.R. 229.402 (Instructions to Item 402(b)(2)(iii)(A)&(13)).
(112) 57 Fed. Reg. at 48134.
(113) 17 C.F.R. 229.402 (Instructions to Item 402(b)(2)(iv), item (v)(E)).
(114) Id.

[Footnote]
(115 Supra note 112.
(116) Sharara, supra note 3 (emphasis added). (117) See Keith A. Mong, Discounted Options as an Alternative to Deferred Compensation, 39

[Footnote]
Tax Mgm't Memo 167 (May 25,1998).
(118) Id.; See also Norma A Sharara, supra note 3 ("In May 1996, SEC completely overhauled the short-swing profit rules for corporate insiders under 16 of the 1934 AcC(citing SEC Rel. No. 34-37261, 61 Fed. Reg. 30376 (June 16,1996)). (119) Brisendine, supra note 71 at 123 ("If diversification of the deferred compensation account balance is contemplated, some would argue that it should not occur earlier than six months from the date the amount equal to the value of the spread... is credited to the deferred compensation plan").
(120) 57 Fed. Reg. at 48143 (citing 17 C.F.R. 119.601(b)(1)(regarding a conforming charge)).

[Footnote]
(121) Norma M. Sharara, supra note 3.
(122) Accounting Principles Board (APB) Opinion No. 25, 110 (Oct., 1972) ("Compensation for services that a corporation receives as consideration for stock issued through employee stock option... plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay"). The "measurement date" is "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive, and (2) the option or purchase price, if any." Id. at I 10b. See also Jim Klein et al., Tax and Accounting Issues for Deferral of Stock Option Gains, 38 Tax Mgmt. Memo 371, n. I (Dec. 22, 1997).

[Footnote]
(123) MacDonald & McGough, Stock Options Take Hidden Toll on Profit, Wall St. J., May 24, 1999; Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995).
(124) MacDonald & McGough, supra note 123. (125) APB Opinion No. 25, 11 Id, states that "Renewing a stock option... or extending its period establishes a new measurement date as if the fight were newly granted." On a "measurement date," the difference between the quoted market

[Footnote]
price of the stock and the amount the employee will be required to pay is recorded as compensation expense. Id. 110; Exposure Draft: Proposed Interpretation; Accounting for Certain Transactions involving Stock Compensation-An Interpretation of APB Opinion No. 25 129, Financial Accounting Series No. 195-13, Question & Interpretation No. 12 (Financial Accounting Standards Bd. 1999) ("[upon] an extension.. that in substance reinstates an option that otherwise would be forfeited... additional compensation cost is recognized to the extent that the intrinsic value of the new award exceeds the original intrinsic value.. of the original award").
(126) Emerging Issues Task Force (EITF) 84-18,

[Footnote]
"Stock Option Pyramiding" (discussed in EITF 87-06, "Adjustments Relating to Stock Compensation Plans" (Jan. 30, 1987), in which it was stated, "some holding period is necessary to avoid the conclusion that the pyramid plan is, in substance, a variable plan for which compensation expense must be recognized, but different Task Force members suggested different periods"); see Norma M. Sharara, supra note 3, at n.51 (Share exchanges involving shares held more than six months would receive fixed accounting treatment").
(127) APB Opinion No. 12, as amended by FASB

[Footnote]
Statement No. 106 (Financial Accounting Standards Bd., 1990). Commentators have argued that if the NQDC benefit will be payable solely in company stock, the company should not be required to record compensation expense on the conversion. See Jim Klein et al., supra note 122. (128) FASB Statement No. 87; Richard Dieter et al., Accounting for Pensions and Deferred Compensation, 393-2nd Tax Mgm't (BNA), at A-6. (129) Jim Klein et al., supra note 122.
(130) FASB, Current Text 1996/97 Edition, Accounting Standards as of June 1, 1996, C47, 119-120. SARs are treated as "variable plans" subject to "variable accounting" because the number of shares, or the price, or both, are not specified until after the date of grant. Id. n.5. (131) FASB Technical Bulletin 85 -4 (Nov. 14, 1985) (FAST 85-4.12 & FAST 85-4.13).
(132) Accounting for Key Person Life Insurance I 24, 25, 27 (American Inst. of Certified Pub. Accountants 1984).

[Footnote]
(133) Id. at 127.
(134) FASB Technical Bulletin 85-4, FAST 854.12 and FAST 85-4.13.
(135) FASB supra note 125 atl 29b.
(136) Status Report 312, Stock Compensation-Interpretation of Opinion No. 25, Financial Accounting Series No. 1965-A, (Financial Accounting Standards Bd. 1999).

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